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Central Intelligence Agency

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DIRECTORATE OF INTELLIGENCE

20 March 1985

Hungary: The Environment for Economic Reform at the 13th Party Congress

State Dept. review completed

SUMMARY

The future course of Hungary's economic reform program will be among the issues with top billing at the Party Congress set to begin 25 March 1985. The package being considered represents a potentially far-reaching new phase of reforms designed to increase economic efficiency and to enhance the economy's ability to adjust to changing foreign and domestic requirements. The dilemma that the Congress will face in deciding on a program is that the long-run benefits promised by the reforms,such as improved export performance, require some short-term dislocation and uncertainty for important interest groups. As it debates these new measures, the party must take heed of the current chorus of complaints from consumers affected by rising prices, workers concerned over greater job insecurity and growing income disparities, and managers resistant to tougher performance standards. [redacted]

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This memorandum was prepared by [redacted] East European Division, Office of European Analysis. It was requested by Paula Dobriansky, Deputy Director, European and Soviet Offices, National Security Council. Comments and questions are welcome and should be addressed Chief, East European Division, Office of European Analysis, [redacted]

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We believe that the Congress will ratify the overall reform program because the leadership sees no alternative path to long-term economic growth and a healthy balance of payments. Nonetheless, the regime will move at a very measured pace in implementation of specific reforms because it recognizes the need for compromise and consensus building among the country's interest groups. Budapest must also continue to watch closely the impact of reforms on its balance of payments and the attitude of Moscow's new leadership toward innovation in Eastern Europe. [redacted] 25X1

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Background

Hungary's reforms have had a rocky, stop and start history since their inception in 1968. At different stages along the way, domestic and external obstacles have forced the regime to slow down, put on hold, or even reverse parts of its program. By all accounts, the authorities have never doubted that systemic change is necessary to promote economic growth and external financial health, but they have weighed carefully the risks of moving too quickly and have adjusted the pace accordingly.

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The forward momentum in reform first came to a halt in 1971. The key factor was probably growing resentment among Hungarian workers over inflation, new policies linking wages more closely to profit, and the large bonuses granted to factory managers. Various reports indicated that Moscow and conservative members of the Hungarian leadership also were alarmed by the poor performance of the Hungarian economy in 1971, particularly large investment overruns and a substantial foreign trade deficit. Budapest increased borrowing from the West and further tightened central controls in the mid-1970s to shield the economy from the oil shocks and rapid global inflation. By 1978, the government began to perceive that its deteriorating hard currency payments position made continuation of these policies untenable in the long run. It decided to revive the economic reform program in order to enhance efficiency in the economy and export competitiveness. The regime moved very cautiously and avoided potentially destabilizing reforms, however, because its serious financial problems--especially in 1981-83--left little room for error.

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The "New Phase" of Economic Reform

Budapest decided to initiate a major new phase of economic reform at a Central Committee plenum in April 1984. Although details about timing and scope were not fully worked out, the plenum put together a broad program of action for the remainder of the decade, with modest initial steps in January 1985 to make prices reflect real costs and to increase wage differentiation in enterprises. The basic features of the new program[1] are:

-- Expanding enterprise authority in choice of product mix and conduct of foreign trade.

-- Giving workers a voice in management of state enterprises and in the selection of chief executives.

-- Continuing the breakup of excessively large, 25X1

[1] For details, see the Appendix to this memorandum 25X1

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monopolistic enterprises and introducing a bankruptcy law providing for liquidation of chronically insolvent firms.

-- Encouraging small scale ventures under both socialist and private ownership.

-- Further liberalizing the rules of price formation and rationalizing the structure of relative prices through reductions in subsidies and in the number of turnover taxes.

-- Promoting greater differentiation in enterprise earnings and workers' wages through reforms of the tax and income distribution systems.

-- Decentralizing the banking system, establishing additional deposit and lending institutions, and creating Western-like securities markets to facilitate the movement of capital among enterprises.

These measures are intended to increase enterprise independence, instill greater competition, and strengthen market forces. If effectively implemented, they should improve the economy's efficiency and responsiveness to domestic and external requirements. [redacted] 25X1

The plenum's decision stemmed from the need to present the new program in sufficient time for debate at the Party Congress. We believe that aging Party Chief Kadar, although fully intending to remain in power for the foreseeable future, wanted to infuse reform more deeply into the Hungarian economy during his tenure in office. He probably recognizes that at 72 his career is winding down after nearly three decades as leader and that it will be several years before a new leader has enough confidence and authority to introduce controversial policies.
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By mid-1984 Hungary was less constrained by external factors, which had hindered reform in the past. Its financial position vis-a-vis the West, though still not as healthy as Budapest would have liked, had improved since the crisis period of 1981-83, and the Hungarians had regained a respectable credit rating from Western bankers. At the same time, [redacted] 25X1
25X1 Budapest believed it had a qualified mandate from Moscow to adopt reforms provided they did not threaten party control. Following the June 1984 CEMA summit, a number of Hungarian officials told the US Ambassador that Moscow indicated that it would tolerate Hungary's reforms--and associated dealings with the West--on the condition that the Hungarians continue to meet their trade and other commitments to CEMA. [redacted]
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With external impediments to reform eased, domestic opposition is now the dominant obstacle to rapid movement. The long run benefits promised by the reform require some short-term dislocation and create uncertainties for important interest groups. The regime faces difficult choices on the role of government and party bureaucracies in economic management, on social welfare and income distribution, and on industrial restructuring. When these issues arise at the Party Congress those involved in the debate will need to take heed of the current chorus of complaints from consumers affected by rising prices, workers concerned over greater job insecurity and growing income disparities, and managers resistant to tougher performance standards.

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Consumers Face Higher Prices

Price reform--an integral element in overall reform because of the need to reduce government subsidies--is one of the most sensitive issues because it usually leads to higher consumer prices.[2] Inflation averaged almost 8 percent annually during 1979-1984 by official estimates, but the actual rate is probably considerably higher because increases in free market and private sector prices are not fully taken into account. Price hikes have been especially hard for the population in recent years because nominal wages have often not kept up with even the official inflation rate. Pensioners and those workers whose income is derived entirely from the public sector have suffered most.

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Western observers and US Embassy officials on the scene for the latest round of consumer price increases in January believe that public discontent was more pronounced than in previous years. The government raised prices as much as 25 to 30 percent for dairy products and household heating and imposed even stiffer hikes on postage and transportation. Although the economic plan for 1985 provides for a small gain in real wages for public sector employees--the first since 1981--many Hungarians are skeptical that the average 8-percent wage increase scheduled will cover the price increases.

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Trade union officials are trying to protect workers' interests without defying government policy. They have publicly expressed concern over the price increases and their effects on low-income families, but, at the same time, admit that they accept government arguments about their necessity. Perhaps to maintain some legitimacy in workers' eyes, one high-ranking

[2] The government also has used price increases during the last few years as an adjustment measure to reduce domestic demand. Although reform measures alone would cause some inflation because of the need to bring domestic prices closer to world levels, a variety of reporting indicates that the average Hungarian blames the reform for all price increases.

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official of the National Trade Union Council (SZOT) publicly stated that SZOT had persuaded the government to set a lower inflation target for 1985 than originally planned. In meetings with US Embassy officers at the end of February, two SZOT officials described a nationally televised explanation of price rises as unintelligible and noted that, while the hikes may be understandable to economists, they make no sense to ordinary Hungarians. [redacted] 25X1

The regime has taken several steps this year--all of which can be construed as backtracking on reform--to try to gain support from those becoming disaffected with price increases:

-- Various pensions, family allowances, and maternity leave benefits were increased. Senior citizens were also exempted from the sharp jump in the cost of public transportation.

-- Budapest also passed temporary legislation that gives the National Material and Price Office greater control over enterprise price setting. The legislation requires all enterprises to submit for prior approval any price increase affecting consumer goods (and certain consumer services), including those in the "free market price" category.

-- Most recently, the Kadar regime made a personnel shift which restored the influence of Sandor Gaspar--former Secretary General of the SZOT, who is a strong supporter of workers' interests. Gaspar had been shunted aside in 1983 after publicly accusing the party of overburdening the industrial worker through excessive price increases. [redacted] 25X1

<u>Private Sector Activity</u>

Thriving private economic activity has had a mixed impact on Hungarian life. On the one hand, the variety and quality of service-oriented businesses and specialty goods shops have grown rapidly in just a few short years, greatly enhancing the quality of Hungarian life. Window shopping down Vaci Street in downtown Budapest, a Western visitor can nearly forget that he is in the Soviet bloc. This new prosperity, however, is not shared evenly among the population and has posed new problems for the regime in terms of ideological contradictions, widening income differentials, corruption, and sociological problems. [redacted] 25X1

The growing divergence in incomes between public sector and private sector employees has been the catalyst for much of the debate. Information provided by Budapest to the International Monetary Fund (IMF) shows that in 1983 and 1984 wages in the socialist sector increased only 5 percent per year, while receipts from private sector activities grew at about 23 percent

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per year. In absolute terms, an unofficial survey of income levels by US Embassy officers found the monthly income of a private cab driver in Budapest to be 6 times the monthly wages of a graduate engineer working for a state organization. [redacted] 25X1

The main supporters of private activity have been the regime and the entrepreneurs themselves. Budapest supports and encourages them because their products fill gaps in state-provided consumer goods and services. Freedom to pursue private work spurs creativity and innovation, which the leadership hopes will spill over into mainstream production and increase hard currency exports. Finally, Budapest undoubtedly hopes to gain some popular support by providing the population with a degree of choice and independence in the economic sphere. [redacted] 25X1

Opponents--ideologically conservative groups and those envious because they lack the opportunity to participate in lucrative pursuits--claim that private activity has led to many undesirable side effects. Complaining in press and journal articles that the emergence of a wealthy class and its conspicuous consumption demonstrate that the reforms are bringing capitalist evils to Hungary, they have been pressing the regime to call a halt. They apparently were not assuaged by government measures in the past few months that increased taxes on profits earned by entrepreneurs and created an economic police unit to crack down on blatant fraud and illegal activity. At the same time, many Hungarian sociologists are alarmed that private entrepreneurs--often moonlighters--are putting enormous pressure on themselves and their families by working very long hours and expecting quick success. Trade union officials have echoed this argument to US Embassy officers, maintaining that a worker ought to receive enough compensation for an eight hour day to maintain a decent standard of living. [redacted]

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Factory-Level Reforms

Budapest's plans for decentralizing decisionmaking and restructuring industry are the source of much anxiety and skepticism for industrial workers and managers alike. Recent editorials in the Hungarian press indicate that workers feel threatened by a system that rewards success and high achievers while leaving behind the old, the less capable, and those with insufficient training. Many enterprise directors, meanwhile, are uneasy about being held personally accountable for performance and profit levels. [redacted] 25X1

Budapest's intent to begin paying workers doing the same job according to individual performance and to close down inefficient firms has long been contentious. Workers and trade union leaders argue, [redacted] that wage differentiation strikes at the very essence of the socialist doctrine of equal distribution of wealth and threatens to take away many of the subsidies and social benefits to which the population has grown

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accustomed. They also argue that the resulting conflict and jealousy among workers would cause a fall, rather than a rise, in labor productivity. Government plans to dissolve or restructure many more unprofitable firms also concern workers, who are skeptical of regime promises that full employment will be maintained or who resist the idea of having to learn new skills. [redacted] 25X1

Hungarian managers are a more diverse group in education, experience, and ideological views than are the workers, and therefore have a broader spectrum of views about reform proposals. The younger generation (those in their mid 20s to perhaps 40), who have received a fair amount of managerial training and tend to have a Western business orientation, are among the strongest public supporters of reform. Those in the older generation, who tend to be less educated and much more conservative, however, are insecure about the new responsibilities they are being asked to shoulder and feel overwhelmed by complex new regulations. They undoubtedly fear that their jobs will be threatened if they fail to perform adequately. Recent press reports suggest that large numbers of enterprise directors are asking the authorities for--and getting--exemptions from even the modest new rules imposed this year. [redacted] 25X1

Workers, union officials, and some managers have misgivings about the participation of workers councils in enterprise management, scheduled to be gradually introduced in 1985-86. Although workers would welcome the opportunity to have a genuine role in making decisions and in electing their factory managers, they probably doubt that the party intends to give up ultimate control over these matters. Union officials have their own parochial interests to protect. They stand to lose a great deal of power at the factory level if workers acquire the means to represent their own interests in mediation with management. Managers seem less concerned. A number have stated in newspaper interviews that they do not expect the introduction of enterprise councils to make a substantial change in the way they do business. One manager summed it up this way, "If the atmosphere within the enterprise is good, if the workers trust the leadership, if the leadership relies on the workers, then the cart moves; if not, if frank talk and demanding care are missing, then the most democratic form is not worth much." [redacted] 25X1

Reform of the Financial System

Budapest's plans for restructuring the credit system are still largely in the conceptual stage. Debates in these more technical areas are being conducted by the leadership, central bankers and highly trained government economists, who are in many cases soliciting advice from the IMF. [redacted] 25X1

Proponents of major reform in this area point to the need

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for competition in the credit market. They believe that even if conditions in the economy (i.e. the low level of available funds) are not ripe for this now, the mechanism should be put in place sooner rather than later. They argue in various journals that it will give enterprise managers greater choice and flexibility in soliciting funds for investment projects and that local bankers familiar with the environment are in a better position to make decisions than centrally located bureaucrats. 25X1

Opponents--including senior National Bank officials who are afraid of losing control over credit allocation in Hungary--have argued that decentralizing the banking system is extremely risky. They probably fear that a decentralized banking system will lead to excessive lending to enterprises and an uncontrollable investment boom, and that inter-enterprise lending could drain resources away from efficient producers to keep money-losing enterprises afloat. Moreover, some have expressed concern to US officials that Hungary's credit rating and balance of payments picture will suffer if individual banks are given the power--and abuse it as in Yugoslavia--to borrow independently on Western financial markets. 25X1

<u>Outlook</u>

We expect the Party Congress--which sets the tone for the nation's development for the next five years--will ratify the program approved last year. The leadership is convinced--and we believe correctly--that it has no alternative to achieve long term economic growth and external stability. At the same time, we expect the regime to move at a very measured pace because it recognizes the obstacles and the need to build a consensus among the country's interest groups. The Hungarians, nonetheless, face the problem that cautious, piecemeal implementation could prevent timely realization of the benefits promised by reform and in turn could strengthen the criticisms of reform opponents. With each step it takes, Hungary becomes increasingly aware that it is the pioneer economic reformer in Eastern Europe with no model to follow and no one to go to for advice. 25X1

To the best of our knowledge, Hungary does not have a blueprint or specific timetable for accomplishing its goals. In the next few years we expect the Hungarians to make some additional progress with price and wage reform, improving the quality of enterprise managers, and decentralizing decisions on production and foreign trade. At the same time, the regime will probably be forced to define more specific limits for private activity and crack down more forcefully on flagrant excesses. We expect more far-reaching and potentially disruptive measures, including widespread closings of bankrupt firms, reorganization of the banking and credit systems, and introduction of a personal income tax will be deferred. 25X1

External factors will continue to be important in

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determining the pace of Hungary's reform effort. Budapest's debt repayment schedule--although more manageable than in the recent past--will remain quite heavy through the end of the decade, and Hungary's ability to earn sufficient hard currency will depend on the strength of Western recovery and trends in world prices for its exports. Budapest's financial picture could be further complicated if its experiments in decentralization lead to deterioration in the foreign trade balance or to expanded borrowing to support excessive enterprise investment. In addition, the Hungarians are uncertain about the attitude of the new Soviet leadership toward reform and toward relations with Eastern Europe. The Hungarians' impression, expressed numerous times over the past year, is that Gorbachev is a pragmatist, who will give them a relatively free rein to improve the efficiency of the economy. Nonetheless, current Soviet efforts to tighten CEMA integration will at least complicate Budapest's effort to reduce state control over economic decisionmaking. A move by Moscow to try to impose even tighter Soviet control over the East European countries or to exploit the East European economies for Soviet benefit would put Hungary's reforms in jeopardy. 25X1

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Appendix

Hungary's New Phase in Economic Reform

The "new phase" of economic reform initiated by the April 1984 Plenum is intended to further curb central interference in enterprise decisionmaking and to expand the role of market forces throughout the economy. This appendix, based largely on recent statements by Hungarian officials and representatives of the IMF and World Bank, provides an overview of the impending changes. Although some initial measures were introduced in January, the timetable for implementing the major portion of the program probably will be a prominent issue at the Party Congress.

Enhanced Enterprise Decisionmaking

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The main thrust of the program is reduction of control by supervisory ministries over managers of state enterprises, while workers are to have some voice in the selection and firing of chief executives. Except in the largest state enterprises such as public utilities and trusts, all operating and investment decisions will devolve to the enterprises. The authority of supervisory state agencies will be restricted to monitoring the legality of enterprise operations, and firms can seek court protection from unwarranted interference. The power to appoint managers and to decide the basic orientation of enterprise activities will be vested in new Enterprise Councils representing both employees and executives in the case of medium and large enterprises and with new Assemblies of Employees in the case of small enterprises. Chief executives, who will be appointed to five-year terms by these bodies, will bear responsiblity for day-to-day operations.

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Competition is to be strengthened by the breakup of more monopolies and the removal of restrictions on the freedom of most firms to choose what they produce. Chronically unprofitable enterprises with outmoded product lines will be subject to a new bankruptcy law. Budapest plans to encourage the further development of small-scale competitive ventures under both socialist and private ownership. In 1982, Budapest adopted legislation to promote the expansion of small and medium sized enterprises in socialized sectors, to legalize private activities in the second economy, and to encourage new private undertakings.

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Freer Rules for Price Formation

A series of measures--the first of which were introduced in January--is designed to give new impetus to price liberalization:

-- An increasing share of prices is to be negotiated between buyers and sellers based on domestic cost and

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demand conditions.

-- The layers of bureaucracy and paperwork associated with the setting and control of prices are to be reduced substantially.

-- Price subsidies not justified by social policies are to be eliminated.

-- Turnover tax schedules are to be greatly simplified.

A chief feature of the new price regulations consists of relaxing the rules in manufacturing industries that (a) restrict profit margins on domestic sales to the average margin achieved by enterprises in convertible currency exports and (b) limit domestic price increases to increases in export prices. Enterprises that can demonstrate substantial exposure to foreign competition and have no monopoly position in the domestic market can apply for exemptions from both of these export-related constraints. In 1984, when these constraints were first lifted, enterprises accounting for about 15 percent of manufacturing output qualified for the liberalized rules; in 1985, with a further relaxation of the criteria, they will account for 40 to 45 percent. [redacted] 25X1

Several safeguards are being retained, however, to prevent excessive price increases. As in the past, producer prices will not be allowed to exceed the prices of imports from convertible currency suppliers. When severe demand-supply imbalances emerge in domestic markets, affected enterprises are to notify central planners in advance of intended price increases. Although formerly rigid rules preventing enterprises from realizing unfair profits will be eliminated, new legislation is intended to prevent abuses of monopoly power, and enforcement of fair market behavior will be partly shifted from state agencies to courts of law. [redacted]

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Wider Income Differentials

Revisions in the wage system are aimed at raising labor and managerial efficiency by stimulating labor mobility, discouraging managers from hoarding manpower, and strengthening profit motivation by linking managers' pay more directly to profits. These measures reinforce the general goal of promoting greater differentials in pay of both workers and executives.

-- To stimulate labor mobility, regulations have been modified to permit a greater differentiation of wages in sectors where enterprises face significant competition from domestic and/or foreign suppliers.

-- To discourage labor hoarding, new laws institute a 10

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percent tax on an enterprises's wage bill.

-- To strengthen profit motivation, remuneration of senior management is to shift from bonuses awarded at the discretion of supervisory authorities toward bonuses based on the ratio of profits to the capital stock.

-- To discourage excessive pay increases, the new wage schemes will continue to feature a highly progressive tax (paid by the enterprises) on either individual earnings or the average increase in the wage bill. In addition, a virtually prohibitive tax of 150 percent is to be applied to wage increases in excess of the rise in value added.

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More Equitable Tax Burdens

A major revamping of the tax system is underway with the aim of taxing profits (and thus efficient enterprises) less while taxing the use of labor, capital, and materials more. The previous 40 percent tax on depreciation allowances and the practice of confiscating a portion of retained profits--both of which weighed disproportionately on profitable enterprises--have been abolished, and the effective rate of profit tax reduced slightly, with a larger reduction planned for 1986. 25X1

According to the government's scenario, key elements of the tax system in the next several years are likely to be a personal income tax and, possibly, a value-added tax (VAT). An income tax would meet the pressing social need to tax incomes from private sector activities more equitably without curbing their vigor. It would also permit a reduction in the overall tax burden on enterprises. Hungarian authorities have requested technical assistance from the IMF in this area as well as in the area of establishing--at a later date--the kind of VAT common in Western Europe.

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Expanded Financial Intermediation

With greater decentralization of decisionmaking elsewhere in the economy, banking officials are giving increased attention to improving the mechanisms for mobilizing and allocating financial resources. Officials say they want to introduce more competition into the banking system and to move toward indirect instuments of monetary control. As a first step, the central banking and credit departments of the National Bank of Hungary have been nominally separated. More substantively, a number of small new banks have been established, enterprises given the right to maintain time deposits with and seek investment credits from any bank, and restrictions lifted that previously limited competition in providing banking services to individuals. Credit ceilings for part of the banking system are being removed even though most

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bank credit will still be subject to direct control and all interest rates other than on inter-enterprise and interbank transactions will continue to be fixed by the National Bank. To promote financial flows outside the banking system, commercial bills of exchange are being introduced and all regulations restricting other forms of inter-enterprise capital transfers are being rescinded.

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